

بالتعاون مع:

مخبر الشراكة والاستثمار في المؤسسات الصغيرة والمتوسطة في الفضاء الأورو مغاربي

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The financial crisis: symptoms & reasons

من إعداد الباحث

Abdeslam HETATACHE  
phone: 0775782268  
[hetalem@yahoo.com](mailto:hetalem@yahoo.com),

Abdelfateh TEBANI  
phone: 0773957766  
\$ fatehfate@yahoo.fr

## The financial crisis: symptoms & reasons

### Abstract:

Economists are at odds about the real reasons of the present financial and economic crisis. Many of whom confuse between the symptoms and the causes of this crisis.

This paper aims at defining and determining the pivotal causes of the crisis; distinguishing it from its symptoms.

To this end, we are going, through this paper, to focus on the shortcomings of the system of capitalism. Accordingly, and through history, the mechanisms of the latter were part and parcel in the previous crises.

In a nutshell, the objective of this paper is to diagnose the disease itself and not its side effects.

### ملخص

يختلف الاقتصاديون حول الأسباب الحقيقية للأزمة المالية والاقتصادية الحالية. بل إن الكثير منهم يخلط بين الأعراض والأسباب الحقيقية للأزمة.

يهدف هذا البحث إلى تحديد الأسباب الرئيسية للأزمة الحالية ، وتبيين الأسباب من العوارض.

من أجل ذلك، سنحاول من خلال هذا البحث التركيز على بيان عيوب النظام الرأسمالي. حيث أن هذا الأخير - وعبر التاريخ- كانت أسسه وميكانيزماته سببا رئيسيا في الأزمات السابقة.

باختصار، الهدف الرئيسي لهذا البحث هو تشخيص الداء عينه دون الاكتفاء بالحديث عن آثاره الجانبية.

### **Introduction**

When the ex-Soviet Union was obliged to apply the capitalist strategies as a last resort to rescue its bankrupting economy, there was a major discussion about a collapse of socialism and a huge triumph of capitalism. Today, and in its turn, capitalism seeks for nationalization as a tool to quell the sharpness of the present financial crisis. The question that is worth to be asked in this respect is: will this crisis resurrect socialism once again?

Throughout its history, capitalism has strictly relied on the consumption tendency and selfishness. The latter is obviously seen in its slogans and mottoes like: *Laissez-faire*, *Laissez-passer*, *the end justifies the means* and *business is business*. Accordingly, it has created two major clubs: one for the rich (20%) and another for the poor (80%).<sup>1</sup>

Economists don't use the word capitalism very much although we talk about capitalism all the time. We just don't name the system as often as we should. For while, it is important to talk about the state of the economy, the weaknesses of the bailout plans proposed and debated, still a certain clarity emerges when their class character is discussed and it becomes clearer why meaningful reform is so hard. These most important questions have a lot to do with how capitalism works, how the economy cannot be separated from politics, and how politics cannot be separated from the distribution of wealth and class power.

This topic, the current financial crisis described as a crisis of capitalism, is the way a lot of the most conservative people in America view our situation, including a goodly number of members of the House of Representatives. Representative Jeb Hensarling, a conservative Texas Republican, tells his fellow representatives that this is no time to abandon free-market principles and start along that "slippery slope to socialism." "How can we have capitalism on the way up, and socialism on the way down?" he asks. How indeed. Representative Thaddeus McCotter, a Michigan Republican, recalls that "peace, land, and bread" was the 1917 slogan of the Bolshevik Revolution. "Today," he told his colleagues, "I suggest that the people on Main Street have said they prefer their freedom, and I am with them." Actually they seem to be saying that they don't want to bail out the banks so they can afford bread, health care, and gasoline. Such conservatives voting to prevent socialism in America do not acknowledge that it is socialism for the rich at the expense of the rest of us. The ideological right wants to save capitalism from the likes of

such dangerous radicals as George W. Bush, Ben Bernanke, and Henry Paulson. This is a comic turn of events. They do not understand that business cycles are integral to the workings of capitalism and have been since its beginnings and that the more extreme form of laissez faire, the more violent the economic crisis.<sup>2</sup>

The whole world is now in the grip of a financial crisis which is far more serious than any experienced over the last four decades. In spite of billions of dollars of bailout and liquidity injections by a number of industrial countries the crisis is showing no signs of abating. There is, hence, a call for a new architecture that would help minimize the frequency and severity of such crises in the future.<sup>3</sup>

Because of its severe ongoing consequences on different levels, the present financial crisis has clearly shown the setbacks and disadvantages of the capitalist regime. Indeed, it showed how this system is so crackly and unreliable. Despite the fact that this system is full of blots, capitalists could deceive humanity and persuade people of the system's coherence and ability to face any obstacle for a long time. Here, in this more general sense, we ask another question: are capitalists still able to mislead the world, especially after this crisis? And will the world also continue winking at the obvious weaknesses of this system?<sup>4</sup>

The word 'subprime' has perhaps become the most often repeated word in the newspapers lately. It's there everywhere. And it lends itself to such complexities that many of us average mortals prefer to know as little of it as possible. Yet, the crisis is not as difficult to comprehend as it is made out to be. It is similar to any other crisis in the sense that it too is the result of 'irrational exuberance'. In this paper, we try and explain in as simple terms as possible what this ugly subprime monster is all about. The term 'subprime' and a little background to the crisis Subprime credit refer to extension of credit facilities to borrowers who have deficient credit history or inadequate documentation. The interest rate applicable in the subprime market is higher because of the higher risk involved in lending to people who do not show adequate credit worthiness. The subprime mortgage market has expanded rapidly in recent years. A decade ago, five percent of mortgage loan were subprime; by 2005 the figure had jumped to approximately 20 percent. Currently, there are about \$1.3 trillion outstanding subprime loans; over \$600 billion of which originated in 2006. The reason for such breakneck expansion of subprime credit is not difficult to fathom. Post 2000, in the aftermath of the dot com bust and the impending recessionary tendencies in the US economy, the Fed had cut interest rates to as low as 1.5 per cent in June 2003, their lowest levels since 1958. Credit was cheaply available and it was scouting for asset markets in which to exhaust itself. It was no surprise that the outlet for deployment of credit came in form of the housing market as home prices had begun to show an uptrend after having bottomed out.<sup>5</sup>

A financial crisis is the situation in which the financial system loses its efficiency to accomplish its main function in moving the financial balances from the economic entities that have a financial surplus (inputs for example) to those entities that need it. This failure in the efficiency is directly related with the pervasive spread of the financial panic (which causes a downfall in the financial assets, and shares in particular) and the bankruptcy of a lots of economic companies (as a result of an increase in bad debts), together with the decadence of the companies financial ability to repay its debts, especially banks, investment and securities companies. All this leads to a major slump in the size of finance allocated for the real investment. Thus, the rate of unemployment rises accordingly.<sup>6</sup>

This definition of the crisis is a true description of the present financial crisis. Yet, the latter is deemed to be one the worst crises ever witnessed in the world economic history, if not the worst, especially after the world economic system had failed to put an end to its devastating consequences, or at least, quell its sharpness quickly and effectually. The danger of this crisis is inherent in the fact that it started in the US economy, which is the largest and the biggest in the world (with the size of \$14 trillion and a foreign trade that

represents 10% of the world trade). For this reason, if ever the American economy is subject to any least danger, this will be, by all means, contagious to the rest of the world.

In this paper, we explore in brief some of the overarching social and political problems generated by the global capitalist system, including the tendency inherent in the system toward instability, inequality, crisis and conflict. In more academic parlance, this research seeks, by way of conclusion, to identify the contradictions of global capitalism and the prospects of an alternative to it.

First and foremost, let's establish what laissez-faire capitalism is. Broadly defined, it is an economic system based on private ownership and control over of the means of production. Under laissez-faire capitalism, government activity is restricted to the protection of the individual's rights against fraud, theft and the initiation of physical force.

### *I- The previous crises*

Before we speak about the current financial crisis in details, let us have a quick glance at the crises that preceded this one, and try to identify the different similarities and differences between them. In addition, we shall note what role the capitalist system played in each one of these crises.

In the last century, the world witnessed a number of financial crises in different countries and regions. The main crises are states bellow as follows:

- The biggest and sharpest crisis ever known is the Great Depression of the late 1920's and the early 1930's (1929-1933) which resulted in a huge decline in shares and wide bankruptcies on a large extent. For instance, one third of the American banks were subject to bankruptcy (roughly 9000 banks). The bank trade loans fell to the half and the unemployment rate rose to an unprecedented level (more than 40% in America alone), accompanied with a fall in the price level and many economic imbalances. Panic selling led the investors and speculators to beat the record in the number of shares sold; in one day (the black Tuesday), more than 3260000 shares were sold for the first half an hour and more than 16410000 shares for the whole day. This record would subsequently last for 39 years ahead. Although the causes of this crisis are still uncertain, the basic cause was a sudden loss of confidence in the economic future. The traditional explanation is a combination of high consumer and business debt, ill-regulated markets that permitted malfeasance by banks and investors. The initial government response to the crisis exacerbated the situation rather than helping the economy. Industries that suffered the most included agriculture, mining and logging. Economists dispute how much weight to give the stock market crash of October 1929. According to Milton Friedman "the stock in 1929 played a role in the initial depression".<sup>7</sup>
- The crisis of the trade banks in the United States in the 1980's (1985-1992); nearly 100 banks were declined each year.
- The crisis of the foreign indebtedness in Latin America (Brazil, Argentina and Mexico): these countries fell in a default of payment and lost its ability to repay its foreign debts because its incomes were not enough to cover its debts.
- The crisis of Black Monday, 17<sup>th</sup> October 1987. The financial markets declined one after another in almost all the world and in a short time. The crisis first started in Hong Kong, then moved to Europe and America in the same day. The decrease recorded at that day was the biggest ever seen in the market history. For instance, in Wall Street, investors and dealers lost more than \$500 billion. Soon enough, the contagion spread over to the other parts of the world. The other stock exchanges followed suit; Hong Kong lost 45.8% of its value, Australia 41.8%, Spain 31% and Britain 26.45%.<sup>8</sup> The interference of the state was part and parcel to overcome the crisis (though this contradicts the

principles of capitalism); for example, Germany imposed a 10% tax on investments and savings.

- The crisis of loans and savings in the United States (1989-1991): 747 lending and saving companies failed to meet its liabilities. However, and as usual, the state interfered to solve the crisis and bore more than \$124.6 billion from \$160.1 billion (the global cost of the crisis).
- The crisis of the Japanese assets during the 1990's: as a reaction to this crisis, the central bank in Japan lowered the interest rates to naught (0%).
- The Asian crisis in 1997 which was characterized by a major drop in the exchange rates and the assets, together with a rise in the Asian countries' indebtedness.
- The Russian financial crisis (or the Rouble crisis in 1998): the low prices of oil and gas (both represented 80% of the Russian global income) were the reason why the oil companies stopped paying taxes. As a result, the exchange rate dropped and the economy was badly affected.
- The Argentinean economic crisis (1999-2002): the local currency declined because of the government inability to pay the value of bonds. This was accompanied by a downfall of the financial sector and an unprecedented unemployment and inflation rates. The latter reached 5000% in 1999 (200% in July alone).
- The crisis of high tech bubble: the economy expanded thanks to the Internet and the high tech boom as investors made money on this new technology, which led others to float the stock of new companies that promised to do the same. Many had no business plan, no chance of ever making money, but the animal spirits of investor/speculators, greed, and the herd mentality bid up prices of such stock until they reached such unrealistic levels that in 2000-2001 the stock market came crashing down. To address the crisis, the Federal Reserve lowered interest rates and kept lowering them. This made it cheaper for companies and individuals to borrow and helped people pay off debt and borrow more. One area that was particularly impacted was real estate: because it is not so much the cost of a home as how much must be paid each month to stay in it that matters, low-interest mortgages made ownership cheaper. As housing prices rose and kept rising, mortgage originators grew lax in their standards. Ninja (no income, no job) loans and little or no down payment became common. To keep the bubble going, low teaser-rate loans which would reset in the future were offered, and interest-only mortgages were popularized; by 2005, adjustable-rate mortgages allowing borrowers to make very low initial payments for the first years were the norm in more than half of new home loans. By 2006, the most popular mortgage option included paying less than the amount due each month, the difference being added to the principal and subject to dramatically higher monthly payments in the future.<sup>9</sup> All these events were the seeds of the current financial and economic crisis which is the subject of the following part of this paper.

## ***II- The current financial and economic crisis:***

The subprime mortgage crisis is an ongoing financial crisis characterized by contracted liquidity in global credit markets and banking systems triggered by the failure of mortgage companies, investment firms and government sponsored enterprises which had invested heavily in subprime mortgages. The crisis, which has roots in the closing years of the 20th century but has become more apparent throughout 2007 and 2008, has

passed through various stages exposing pervasive weaknesses in the global financial system and regulatory framework.

### ***1) The chronology of the crisis:***

In details, we will state the most important chronological events of the current crisis starting from 2007 as follows:<sup>10</sup>

**Wednesday, February 7, 2007:** HSBC announces losses linked to U.S. subprime mortgages.

**Wednesday, June 2007:** Two Bear Stearns-run hedge funds with large holdings of subprime mortgages run into large losses and are forced to dump assets. The trouble spreads to major Wall Street firms such as Merrill Lynch, JPMorgan Chase, Citigroup and Goldman Sachs which had loaned the firms money.

**Thursday, August 9, 2007:** Investment bank BNP Paribas tells investors they will not be able to take money out of two of its funds because it cannot value the assets in them, owing to a "complete evaporation of liquidity" in the market. The European Central Bank pumps 95bn euros (£63bn) into the banking market to try to improve liquidity. It adds further 108.7bn euros over the next few days. The US Federal Reserve, the Bank of Canada and the Bank of Japan also begin to intervene.

**Friday, August 17, 2007:** The Fed cuts the rate at which it lends to banks by half of a percentage point to 5.75%, warning the credit crunch could be a risk to economic growth.

**Monday, September 3, 2007:** German corporate lender IKB announces a \$1bn loss on investments linked to the US sub-prime market.

**Friday, September 14, 2007:** Depositors withdraw £1bn from Northern Rock in what is the biggest run on a British bank for more than a century. They continue to take out their money until the government steps in to guarantee their savings.

**Tuesday, September 18, 2007:** The US Federal Reserve cuts its main interest rate by half a percentage point to 4.75%.

**Thursday, December 6, 2007:** US President George W Bush outlines plans to help more than a million homeowners facing foreclosure.

**Monday, January 21, 2008:** Global stock markets, including London's FTSE 100 index, suffer their biggest falls since 11 September 2001.

**Thursday, January 31, 2008:** A major bond insurer MBIA, announces a loss of \$2.3bn – its biggest to date for a three-month period -blaming its exposure to the US sub-prime mortgage crisis.

**Sunday, February 10, 2008:** Leaders from the G7 group of industrialized nations say worldwide losses stemming from the collapse of the US sub-prime mortgage market could reach \$400bn.

**Sunday, February 17, 2008:** British government nationalizes Northern Rock.

**Friday, March 7, 2008:** In its biggest intervention yet, the Federal Reserve makes \$200bn of funds available to banks and other institutions to try to improve liquidity in the markets.

**Tuesday, April 8, 2008:** The International Monetary Fund (IMF), which oversees the global economy, warns that potential losses from the credit crunch could reach \$1 trillion and may be even higher. It says the effects are spreading from sub-prime mortgage assets to other sectors, such as commercial property, consumer credit, and company debt.

**Tuesday, April 15, 2008:** Confidence in the UK housing market falls to its lowest point in 30 years.

**Wednesday, June 25, 2008:** Barclays announces plans to raise £4.5bn in a share issue to bolster its balance sheet. The Qatar Investment Authority, the state-owned investment arm of the Gulf state, will invest £1.7bn in the British bank, giving it a 7.7% share in the business. A number of other foreign investors increase their existing holdings.

**Friday, July 11, 2008:** American Federal regulators seize IndyMac Bank after it succumbs to the pressure of tighter credit, tumbling home prices and rising foreclosures. IndyMac is the largest thrift ever to fail in the United States. Barrel of oil hits a record price of \$ 147.5.

**Monday, July 14, 2008:** Financial authorities step in to assist America's two largest lenders, Fannie Mae and Freddie Mac. As owners or guarantors of \$5 trillion worth of home loans, they are crucial to the US housing market and authorities agree they could not be allowed to fail.

**Monday, September 1, 2008:** Official figures from the Bank of England show a slump in approved mortgages for July. Meanwhile, while the pound falls to record lows of 81.21 pence against the euro and two-year lows of \$1.80.

**Friday, September 5, 2008:** A raft of negative news from around the world sees the FTSE notch up its steepest weekly decline since July 2002.

**Sunday, September 7, 2008:** Mortgage lenders Fannie Mae and Freddie Mac - which account for nearly half of the outstanding mortgages in the US - are rescued by the US government in one of the largest bailouts in US history. Treasury Secretary Henry Paulson says the two firms' debt levels posed a "systemic risk" to financial stability and that, without action, the situation would get worse. At the same time, in the UK, the Nationwide announces it will merge with two smaller rivals, the Derbyshire and Cheshire Building Societies.

**Friday, September 12, 2008:** With Lehman Brothers facing collapse, the Department of the Treasury struggles to find a white knight for the distressed investment bank.

**Monday, September 15, 2008:** Bank of America agrees to a \$50 billion rescue package for Merrill Lynch. Lehman files for bankruptcy and thousands of its employees are told it's all over. This is the largest bankruptcy filing in the history of the United States, \$ 639 billion. Shares in European stock exchanges plunge. FTSE 100 closes almost 4% lower at 5,202.4, a 210 point drop. U.S. officials agree to put together a \$20 billion lifeline bid for insurance giant AIG. The Dow Jones Industrial average plunges 504 points to close at 10,917.51.

**Thursday, September 18, 2008:** Russian stock markets remain closed for a second day. There is even more panic in Asia, where the Nikkei drops 260 points to 11,489. It is formally announced that HBOS will be taken over for £ 12.2 billion. Gold reaches a six-week high as investors flee shares and pile into commodities. Central banks around the globe inject \$180 billion into the international banking system in a concerted effort to end the crisis. The U.S. Federal Reserve cuts its main interest rate by half a percentage point to 4.75%, its first cut since 2003.

**Saturday, September 20, 2008:** The U.S. Secretary of the Treasury, Henry Paulson, spends the weekend trying to thrash out his \$ 700 billion "bailout" plan.

**Thursday, September 25, 2008:** Ireland becomes the first state in the Euro-zone to fall into recession. The American bailout plan appears to have stalled. President Bush meets with Barack Obama, John McCain and Congressional leaders to discuss a plan of action.

**Thursday, October 2, 2008:** The U.S. Senate approves the bailout. Congress passes the \$700 billion asset relief bailout. European leaders, led by French president Nicolas Sarkozy, consider their own bailout, which would cost € 300 billion.

**Thursday, October 9, 2008:** The IMF announces emergency plans to bailout governments affected by the financial crisis, after warning that no country would be immune from the ripple effects of the credit crunch. The Dow falls to a five-year low, ending the day at 8,579 points. The FTSE ends at 4,313.8 its lowest level since August 13, 2004.

**Friday, October 17, 2008:** French savings bank Caisse d'Épargne announces a loss of € 600 million.

**Sunday, October 19, 2008:** Details emerged that Dutch savings bank ING was to get a € 10 billion capital injection from Dutch authorities. South Korea announces a \$ 130 billion



financial rescue package to stabilize its markets. It further promises to guarantee bank's foreign debts and to inject capital into struggling financial firms if necessary.

**Monday, October 20, 2008:** Sweden's government sets out its own bank rescue plan, with credit guarantees to banks and mortgage lenders up to a level of 1.5 trillion kroner (\$ 205 billion).

**Sunday, November 9, 2008:** China announces a two-year \$ 586 billion stimulus package to help boost the economy by investing in infrastructure and social projects and by cutting corporate taxes. Economic growth has slowed in China with sharp drops in property and stock values.

**Saturday, November 15, 2008:** International Summit in Washington to reinvent the international financial system. Leaders agreed to cooperate with respect to the global financial crisis and issued a statement regarding immediate and medium term goals and actions considered necessary to support and reform the international economy.

**Sunday, 23 November 2008:** Citigroup is bailed out in an asset-relief package worth \$306 billion and a further \$20 billion recapitalization (on top of an earlier \$25 billion).

**Saturday, 6 December 2008:** The German parliament completed passage of a €31 billion (\$39.6 billion) stimulus program, while October manufacturing orders fell and the central bank warned of a considerable contraction ahead. The Reserve Bank of India on Saturday announced sizable cuts in its key short-term interest rates, sending a signal to banks to bring down lending rates as it scrambles to protect the real economy from a worsening global financial crisis.

**Monday 5 January 2009:** The Federal Reserve Bank of New York begins purchasing fixed-rate mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae under a program first announced on November 25, 2008.

**Friday, 9 January 2009:** More US workers lost jobs last year than in any year since World War II, with employers axing 2.6 million posts and 524,000 in December alone. Spanish industrial output fell by 15.1% in November, compared with the same month one year ago, the biggest fall on record and a sign of a deep recession.

**Friday, 16 January 2009:** Citigroup capped a devastating 2008 by announcing Friday that it would split into two entities and that it had posted an \$8.29 billion loss for the fourth quarter.

**Thursday, 22 January 2009:** Microsoft has said it will cut up to 5,000 jobs over the next 18 months, including 1,400 immediately.

**Friday, 23 January 2009:** Samsung Electronics, the world's biggest chip-maker, has recorded its first ever quarterly loss.

**Monday, 26 January 2009:** Philips cuts 6,000 jobs after first loss in five years. Europe's biggest electronics consumer group reports net €1.5bn (£1.4bn) loss in the final quarter of 2008.

**Tuesday, 27 January 2009:** The Canadian government has said it will "spend whatever is necessary" to stimulate the country's economy in the midst of the global economic downturn.

**Tuesday, 3 February 2009:** Australia's government has announced a 42bn Australian dollar (\$26.5bn; £19bn) stimulus plan, targeting infrastructure and those on low incomes. The country's central bank also cut interest rates to 3.25% - the lowest level in 45 years.

**Monday, 9 February 2009:** Nissan to cut 20,000 jobs worldwide.

**Friday, 13 February 2009:** Congress on Friday approved a \$787 billion economic stimulus measure, meeting the crushing mid-February deadline that Democrats had set for adopting the centerpiece of President Obama's early agenda but without quelling partisan divisions in Washington. Not a single House Republican voted for the bill.

**Sunday, 22 February 2009:** European leaders in Berlin have agreed on the need to regulate all financial markets including hedge funds.



**Wednesday, 25 February 2009:** Japan's exports fell by 46 percent in January, and Hong Kong's economy contracted 2.5 percent in the last three months of 2008, further signs that the economic downturn in Asia is set to drag on through this year.

**Wednesday, 4 March 2009:** Japan's parliament has passed legislation to give a cash hand-out to every resident in attempt to boost the recession-hit economy.

**Friday, 6 March 2009:** The US jobless rate jumped in February to 8.1%, according to official figures from the Labor Department.

**Tuesday 10 March 2009:** Trading on Syria's stock exchange has officially begun, marking a crucial step as the country liberalizes its state-controlled economy.

**Wednesday, 18 March 2009:** The US Federal Reserve says it will buy almost \$1.2 trillion (£843bn) worth of debt to help boost lending and promote economic recovery.

**Saturday, 21 March 2009:** US insurance giant AIG paid out a total of \$218m (£150m) in bonuses after accepting bail-out cash, according to a senior US official.

**Monday 23 March 2009:** The US has announced details of a plan to buy up to \$1 trillion (£686bn) worth of toxic assets to help repair banks' balance sheets.

**Monday, 30 March 2009:** President Barack Obama has given US carmakers General Motors (GM) and Chrysler strict deadlines to restructure before getting more aid. Prime Minister Vladimir Putin has said that Lada-owner Avtovaz could be bailed out by the government.

**Friday, 3 April 2009:** The US dollar rose briefly above 100 yen in Asian trading on Friday, the first time it had done so since early November 2008.

**Tuesday, 28 April 2009:** The Lithuanian economy shrank by 12.6% in the first quarter of 2009 compared with the same period last year, the country's statistics office has said.

**Thursday, 30 April 2009:** Unemployment across the 27 EU member states reached 20 million.

**Monday, 4 May 2009:** Italian carmaker Fiat has begun efforts to win support for its plan to take over General Motors' European business, which includes Vauxhall and Opel.

**Thursday, 7 May 2009:** The European Central Bank (ECB) has cut interest rates in the Euro zone to a record low of 1%, down from 1.25%.

**July 8-10.** The G8 Summit in Italy included a dialogue with five developing countries (Brazil, China, India, Mexico, and South Africa). The summit resulted in declarations or statements dealing with Responsible leadership for a sustainable future, Non Proliferation, Counter Terrorism, Promoting the global agenda, Energy and Climate, G8-Africa Partnership on Water and Sanitation, and Global Food Security.

**Saturday, 29 August 2009:** the number of bankrupt banks in the US jumped to 84 from the very beginning of the crisis.<sup>11</sup>

## ***2) The superficial and real reasons of the crisis:***

In the superficial reasons, we will speak about the criticisms given to the governments and the financial institutions concerning the bad policies and regulations which participated in deepening and widening the bad effects of the crisis; while in the real reasons of the crisis, we will focus on how the capital system itself generates crises. i.e. the crises are a part of this system and the current one is just one of them.

### ***a- The superficial (shallow) reasons:***

The story is by now well known. Debt financing grew to an extent the repayment capacity of the borrowers could no longer sustain. This was most visible in the housing sector in the United States of America. But it pervaded all sectors of the economy almost all the world over. With so much debt floating in the market, securitization and repackaging took the debts to the common people and those managing their savings. The

easiest way to make money grow became, not productive enterprise, but manipulating other people's debts. Complex derivatives and risk absorbing products like Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDSs) attracted the financial institutions entrusted with investing people's money for profit. Monetary authorities also obliged financial markets with supply of cheap money. Higher and higher leverage became order of the day. When the inevitable bursting of the bubble occurred and defaults became endemic, financial institutions failed to fulfill their obligations. Liquidity dried up. Things stopped moving. Globalization ensured that these effects reached everywhere.<sup>12</sup>

On the other hand, and as the bubble inflated, the Securities and Exchange Commission changed the rules to allow investment banks to take on a great deal more risk, a disastrous decision that led to the collapse of Wall Street as we have known it. The big investment banks asked for and got from the SEC exemption from regulation limiting the amount of debt they could take on. After the change, they no longer had to keep the billions of dollars in safety-cushion reserves against possible bad investments. From then on, with very little of their own money, they could leverage themselves to greater extremes, that is, borrow and invest more in relation to the actual capital the bank possessed. On the up side, this meant they could make great profits with exotic and non-transparent financial instruments and simpler ones which were as it turned out far more risky than they thought. Without the protective buffer of greater reserves, however, they quickly ran out of money when things began to go bad and they could not sustain the extent of leverage which for Bear Stearns, a us famous bank that went bankrupt, **was short-term debt 33 times the value of capital they held.** The SEC examiners pointed out the growing problem before the banks publicly were seen to be in grave danger, but these warnings were ignored by political appointees at the top of the SEC itself<sup>13</sup>.

By allowing the banks to self-regulate and making it more difficult for the staff to investigate and go after companies the staff believes to have broken the law, the SEC, as in the case of many other executive branch agencies, moved the country away from social responsibility to laissez faire at serious cost to the American people. The pendulum will now shift. How far and for how long depends on how deep the crisis becomes and how the American public learns to think about why they are suffering and what can be done. This is a question which we shall try to answer.

Even if you were a banker who saw where all this was heading, you could not refuse to play. If you did, your bank would earn less than its competitors, your stockholders would wonder why they shouldn't get someone else who could increase the profits, and you would be out of a job. If you were the person handing out the loans and interviewing people, your income depended on how many loans you originated. What happened to them after that was not your problem. You will have earned your bonus. The banks learned to securitize these loans -- that is, to gather a bunch of them, some millions of dollars worth, and sell these collateralized debt obligations to someone else who would receive the income. You would get paid up-front with money you could lend to still more borrowers. Since the values kept rising and defaults for years were very low, the rating agencies thought these were safe instruments. Government regulators saw nothing wrong. They mostly came from the banking industry, at least the political appointees at the top did, and they laid down policy. Between mid-2000 and 2004, American households took on three trillion dollars in mortgages. Interestingly, during these same years, the U.S. private sector borrowed what Business Week calls "an astonishing \$3 trillion" from the rest of the world. Between a third and half of the mortgages were financed with foreign money. Banks, especially in Europe, hold a lot of the toxic securitized debt. Some of their banks are in more trouble than us ones thanks to these unwise purchases of presumably "safe" assets.

When the inevitable crash happened and the air went out of the bubble, the nature of what banks do became central. Banks have liabilities to their depositors and others

which are short-term. People can demand their money back when they want or, in the case of money borrowed at low rates for short-term loans, very soon. The banks' assets are their long-term loans including twenty- and thirty-year mortgages. If these mortgages and other loans begin to look risky and it seems the banks may not get their money back, those who have lent money to the banks panic and want their money now. The banks don't have it. This is a liquidity problem. The purpose of FDIC insurance is to calm those who have lent to the bank. But today much bank borrowing is in large money market deposits, commercial paper in large denominations, and interbank borrowing, none of which is insured, so it's hard to come by these days. Thus a liquidity problem. But if the banks hold assets which are worth less than their liabilities this is a solvency crisis. What we are watching is a spreading solvency crisis in which the value of assets is falling, from the value of homes, to the value of the mortgages and the collateralized debt obligations based on these assets, to other collateralized debt obligations based on car loans and credit card payments as the broader economy weakens<sup>14</sup>.

***b- The real reasons of the crisis:***

In 1889, Francis Fukuyama wrote an essay in the influential policy magazine *National Interest* that would become famous. Elated by the collapse of the soviet bloc, Fukuyama declared that the apparent triumph of “liberal capitalism” represented “the End of History”. Fukuyama meant not that history with a small *h* had come to end but that human society had reached its pinnacle with liberal capitalism, the end of the line in the historical progression. The “End of History thesis” quickly came to symbolize the exuberance of global elite in the early 1990's over what they saw the definitive triumph of capitalism over any alternative system.

The belief that the global capitalist system had entered a new golden age of permanent stability, growth, and prosperity for an increasing number of people around the world did indeed seem unshakable for a time. Such political development as the failure of the third world revolutionary experiments, the fall of the Berlin wall in 1989, and the collapse of the Soviet Union three years later, along with defeatist resignation among leftists and popular forces around the world, gave crease to the forging of the new liberal “Washington consensus” in the 1980's and 1990's. The WTO (World Trade Organization) came into existence in 1995, in extraordinary period of (relatively) high growth rates, mild recession and abundant new opportunities for profit making in the informatics-based “New Economy”. All this created a drunken triumphalism among the transnational elite.<sup>15</sup>

But this scenario began to change in the final years of the 20<sup>th</sup> century. The end of “the End of History”, Fukuyama's theory, started with the East Asian financial meltdown (1997-98). The economic turmoil in East Asia quickly spread to Turkey, Russia, Brazil and elsewhere, sending shock waves throughout the financial world and shattering the confidence of the transnational bourgeoisie. The world economy recovered momentarily in 1999, only to sink into a deep recession in 2001. All this led the capitalist world to shift from the offensive to the defensive as the system began to enter a crisis of legitimacy. The corporate megascandals that followed in the wake of the Enron debacle of 2001-2002 further undermined the legitimacy of the global corporate order.

In what follows, we will explain how the system of capitalism itself generates crises by starting with criticizing some of its basics:

Capitalism as a system has spawned a technological dynamism, an increase in society's forces of production, and a social surplus greater than that of any other system humanity has known. But as capitalism produces vast amounts of wealth, it also generates, as a tendency inherent to the very way the system functions, social polarization and crisis. **This polarization and crisis are not the result of “bad policy” but something built into the nature of the system.** By definition, under capitalist-production-relations, workers

produce more goods and services than they are actually able to purchase with their wages. Capitalists would not invest their money if they were not assured a profit or a portion of the wealth produced by the laborers whom they hire. It is only by selling in the market the goods and services produced by workers that capitalists actually acquire their profit. The capitalist uses the proceeds from the sale of these goods and services to pay wages to workers and retains what is left over as profit. If the price fetched for these goods and services were exactly equal to the wages paid to the workers who produced them (along with overhead costs), there would be nothing left over for profit and the investor would have no incentive to invest. Some variants of crisis theory focus on the lack of opportunity to make a profit as the root cause of economic crises under capitalism. Crisis sets in. According to these accounts, when investors hold onto their capital rather than investing it because they perceive that conditions for making a profit are not present. When this happens-when investment does not take place - enterprises close, workers are laid off, growth ceases, and so forth, precipitating an economic crisis.

But the analysis of twenty-first-century global capitalism focuses on a related dimension, that of overproduction or underconsumption. An investor only makes a profit by selling the goods and services produced in the market.

If something is produced but not actually purchased by people, there is no profit. Yet, workers cannot purchase the entire amount of goods and services they produce since their wages must be less than the value of those goods and services. Of course members of the capitalist class and middle strata, governments, and other customers may purchase a portion of these goods and services. Nonetheless, in the abstract, the capitalist class faces the perennial problem of having to find new outlets-markets--to unload the "excess" goods and services their workers produce. So long as new markets are constantly opened up, the process of capital accumulation continues. But at some point, capitalists as a group, or some among them, are left with more goods and services produced by their workers than they are able to market. At that point what is known in crisis diary as the "realization problem" sets in, meaning that wealth generated though investment cannot be marketed and hence profits cannot be made. This is the point at which economic recession typically sets in. this is also known as the crisis of overproduction or underconsumption, since society is unable to consume the wealth it has created given the nature of capitalist relations. To sum up, we can say that global capitalism faces an intractable crisis of overaccumulation.

One of the ideological constructs of the global capitalist system is to treat poverty and inequality as if it were a problem of scarce resources or insufficient growth. It is neither; the world grows enough in basic grains alone for every man, woman, and child to consume 3,600 calories per day. A study of famine periods in Third World regions in the second half of the twentieth century shows that "hungry countries" produced food in abundance and exported foodstuffs to the world market even during the most critical periods of famine. The problem of hunger and deprivation more generally, **is not a lack of resources but how resources are allocated and distributed** and who -what social groups and classes- exercises control over resources and how they are put to use, Nor is the problem of insufficient growth; The 1980s and 1990s were largely a time of sustained growth in the world economy, yet also a time of declining living standards for most people in the world<sup>16</sup>.

Broad swaths of humanity have experienced absolute downward mobility. Even the IMF was forced to admit in a 2000 report that in "recent decades, nearly one-fifth of the world population has regressed. This is arguably one of the greatest economic failures of the 20th century". While global per capita income tripled over the period 1960-94, more than a hundred countries had per capita incomes in the 1990s that were lower than in the 1980s, in some cases lower than in the 1970s and 1960s.

The gap between the world's richest and the world's poorest has grown exponentially. The data on global inequalities provided by the UNDP (UN Developing Program) in its annual Human Development Report have now become well known but do not cease to shock. The assets of the two hundred wealthiest people in the world in 1998 were greater than the total income of 41 percent of the world's population. The three richest people in the world in that year-Bill Gates, Warren Buffets, and Paul Allen-had total assets of \$156 billion, more than the combined GDP of the 43 least developed countries in the world home to 600 million people. Globalization, stated the UNDP (1999), had brought about increased prosperity but concentrated wealth among the "ultra-rich". But beyond the super-rich were layers of affluent people eating at the trough of global capitalism and leaving ever further behind the vast majority of humanity. In 1999 the richest 20 percent of humanity received 85 percent of the world's wealth, while the remaining 80 percent of humanity had access to 15 percent of the world's richest and the poorest 20 percent received only 1.0 percent (UNDP 2001). (See table 1).

**Table1. Shares of Total Income, 1965-1990**

Population	Percentage of Total World Income			
	1965	1970	1980	1990
Poorest 20%	2.3	2.2	1.7	1.4
Second Poorest 20%	2.9	2.8	2.2	1.8
Third richest 20%	4.2	3.9	3.5	2.1
Second richest 20%	21.2	21.3	18.3	11.3
Richest 20%	69.5	70.0	75.4	83.4

**Source:** William I. Robinson, *A theory of global capitalism: production, class, and state in a transnational world Themes in global social change*, JHU Press, USA, 2004, p 153.

The result of globalization "is a grotesque and dangerous polarization between the people and countries that have benefited from the system", asserted the 2000 report, "and those who are mere passive receivers of its effects" (UNDP 1999).The gap between the global rich and the global poor is becoming an ever more gaping chasm, growing at a rate unprecedented in modern human history. This is the *new global social apartheid*.

The British political economist Alan Freeman has compiled and analyzed an impressive set of data on trends in world income and poverty from a number of databases, among them several U.N. and WB agencies, the IMF'S World Economic Outlook database, the U.S. Bureau of the Census, and the University of Groningen's Growth and Development Centre. Freeman documents the steady growth in global inequality and income polarization, as well as the decline in absolute terms of income and the rise in poverty for billions of people, from 1980 to zoom. In 1980, 118 million people lived in nine countries where income per capita was declining; in 1998, there were 60 such countries and 1.3 billion such people. While the rate of growth in world GDP has declined in each decade since 1970, the growth rate for per capita GDP actually became negative in the 1990s (see table 2).

**Table2. growth rate of world GDP and GDP per capita, 1970-1990**

	World GDP	Per capita GDP
1970-1980	5.51	3.76
1980-1990	2.27	0.69
1990-2000	1.09	-0.19

**Source:** William I. Robinson, *A theory of global capitalism: production, class, and state in a transnational world Themes in global social change*, JHU Press, USA, 2004, p 154.

In the past, at least, two mechanisms helped to offset the crises of social polarization and overaccumulation as noted previously. First, classical imperialism allowed

core countries to displace to the colonial world some of the sharpest social antagonisms that capitalism generated, and then brute force was applied to the colonized regions. Second, Keynesian absorption mechanisms, such as credit creation and redistribution through taxation and social spending, offset overaccumulation crises. Many, if not all, of these recurrent crises were mediated by the nation-state. Under globalization the nation-state is less able to address these manifold crises. Yet the emergent TNS is not equipped to resolve them, especially those of overaccumulation and social polarization. Even if the chaotic global financial system could be brought under regulation, the mechanisms simply did not exist for absorption strategies, nor did the system provide a material base for a project of legitimation.

### *III- The possible alternative system to capitalism*

From the reasons seen above we find out that the system of capitalism is unfair and immoral. Additionally, there's a misapplication of the monetary and financial policies like the interest rates. This is usually accompanied with corruption and distortion in the financial records and data in general.<sup>17</sup>

**“The global economic crisis sparked by the US subprime mortgage meltdown would not have occurred if Islamic principles were applied in international financial markets”**, an Islamic scholar said. According to a recent survey, Islamic finance assets are growing at an annual pace of 20% and are set to hit \$2 trillion in 2010 from the current \$900 billion, fuelled in part by a flood of petrodollars generated by the rise in energy prices. Since the capitalist values are the crucial reasons of the system's crisis, the Islamic morals can be a useful alternative to it and a remedy to the system's wounds.<sup>18</sup>

One of the most important objectives of Islam is to realize greater justice in human society. According to the Qur'an a society where there is no justice will ultimately head towards decline and destruction. Justice requires a set of rules or moral values, which everyone accepts and faithfully complies with. The financial system may be able to promote justice if, in addition to being strong and stable, it satisfies at least two conditions based on moral values. One of these is that the financier should also share in the risk so as not to shift the entire burden of losses to the entrepreneur, and the other is that an equitable share of financial resources mobilized by financial institutions should become available to the poor to help eliminate poverty, expand employment and self-employment opportunities and, thus, help reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. For this purpose, one of the basic principles of Islamic finance is: "No risk, no gain". This should help motivate the financial institutions to assess the risks more carefully and to effectively monitor the use of funds by the borrowers. The double assessment of risks by both the financier and the entrepreneur should help inject greater discipline into the financial system, and go a long way in reducing excessive lending.

Islamic finance principles stipulate that deals must be based on tangible assets and require tight controls on debt levels, features analysts say offer some protection to investors and ensure corporate accountability.

Islamic finance should, in its ideal form, help raise substantially the share of equity and profit-and-loss sharing (PLS) in businesses. Greater reliance on equity financing has supporters even in mainstream economics.

Greater reliance on equity does not necessarily mean that debt financing is ruled out. This is because all the financial needs of individuals, firms, or governments cannot be made amenable to equity and PLS. Debt is, therefore, indispensable, but should not be promoted for inessential and wasteful consumption and unproductive speculation. It rather

requires the creation of debt through the sale or lease of real assets by means of its sales- and lease-based modes of financing (*murabahah*, *ijarah*, *Salam*, *istisna* and *sukuk*). The purpose is to enable an individual or firm to buy now the urgently needed real goods and services in conformity with his/her ability to make the payment later. It has, however, laid down a number of conditions, some of which are:<sup>19</sup>

1. The asset which is being sold or leased must be real, and not imaginary or notional;
2. The seller must own and possess the goods being sold or leased;
3. The transaction must be a genuine trade transaction with full intention of giving and taking delivery;
4. The debt cannot be sold and thus the risk associated with it cannot be transferred to someone else. It must be borne by the creditor himself.

The Islamic approach to risk is realistic but cautious. It does not allow deals involving excessive uncertainty (*gharar kathir*). It encourages sharing arrangements for facing risks. The additional wealth created with the use of existing wealth through risky ventures should be shared between fund users and fund owners while both bear the risks involved and the resulting losses. Differences in the participants' perception of risks involved will be decisive in determining the terms of bargain between those sharing risks. Even though the motive of each party is making profits, it is very different from taking chances in gambling. There is real wealth to be created, real gain to be reaped. It is different in case of risk shifting [as in CDS]. Neither the buyer nor the seller of risk has any stakes in real wealth creation. As in gambling only one party actually gains, either the seller of risk or the buyer. It is different in risk sharing in which both parties gain (or lose). Like gambling, risk shifting is a zero sum game.<sup>20</sup>

Risk-sharing fits in with a system that integrates risk management with value creation. The Islamic institutions of *musharakah*, and *mudarabah*, for example target value creation and are good ways of managing risk. In a healthy venture fear of loss works to counter-balance hope for gain. When a system allows shifting the risk (at a cost) the fear factor becomes inoperative insofar as the seller of risk is concerned. It is worse when the government takes over the risk (as in case of Fannie Mae and Freddie Mac in USA). Such a system is heavily tilted towards the rich and leads to greater inequality as it protects the lenders but leaves the borrowers to fend for them selves. This is the feature of the current system that lead to an almost universal cry that it amounted to privatizing gain and socializing pain---profits go to the corporations, losses are borne by the taxpayers.

Thus we can see that the Islamic financial system is capable of minimizing the severity and frequency of financial crises by getting rid of the major weaknesses of the conventional system. It introduces greater discipline into the financial system by requiring the financier to share in the risk. It links credit expansion to the growth of the real economy and minimizes *gharar* and *qimar* by allowing credit primarily for the purchase of real goods and services which the seller owns and possesses and the buyer wishes to take delivery. It also requires the creditor to bear the risk of default by prohibiting the sale of debt, thereby ensuring that he evaluates the risk more carefully. In addition, Islamic finance can also reduce the problem of subprime borrowers by providing credit to them at affordable terms. This will save the billions that are spent after the crisis to bail out the rich bankers. This does not help the poor because their home may have already become subject to foreclosure and auctioned at a give-away price.

On the other hand, there's no doubt that a number of countries have, established special institutions to grant credit to the poor and lower middle class entrepreneurs. Even though these have been extremely useful, there are two major problems that need to be resolved. One of these is the high cost of finance ranging from 30 to 70 percent in the interest-oriented microfinance system. This causes serious hardship to the borrowers in servicing their debt. It is, therefore, important that, microcredit is provided to the very poor on a



humane interest-free basis (*qard hasan*). This may be possible if the microfinance system is integrated with *zakah* and *awaqf* institutions. For those who can afford to bear the cost of microfinance, it would be better to popularize the Islamic modes of profit-and-loss sharing and sales- and lease-based modes of finance not only to avoid interest but also to prevent the misuse of credit for personal consumption. The problem, of course, is that Islamic finance has at present a very small share of global finance. However, it is the ability of the system to solve a problem that matters. If Muslims themselves establish the system genuinely and successfully with proper checks and controls, the whole world will ultimately come around to it.<sup>21</sup>

## Conclusion

In this humble exposé, we tried to shed the light on the main causes of the current financial crisis that is leading the world into an economic disaster of unprecedented proportions. This is followed by a discussion on how the system of capitalism generates crises and widens the rift between the richest and the poorest people in the world. We came out that the problem is not in the bad policies, but in the system itself. In this regard, we stated many critics by famous economists that are address this system.

Through this paper, we exposed, what we thought is an alternative to capitalism i.e. the Islamic system, to get out of this undesirable situation and move towards a better world because at such times, people begin to say if this is how capitalism works it is time to figure out something better.

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